

Final Report of the Illinois Commerce Commission's Post-2006 Initiative

**To Governor Rod R. Blagojevich and
The Illinois General Assembly**

Executive Summary

The Electric Service Customer Choice and Rate Relief Law of 1997 ("Restructuring Act") initiated an unprecedented restructuring of the State's electric power industry with the goal of developing an effectively competitive electricity market in Illinois. The new law provided Illinois electric utilities the opportunity to restructure their businesses, mandated a reduction in rates for residential customers and a rate freeze for all customers, and allowed customers the opportunity to achieve savings by purchasing electricity supply from alternative retail electric suppliers. As a result of the Restructuring Act's directives, dramatic and positive changes have occurred in the industry:

- Residential customers have benefited from one of the largest and longest rate reductions, and today are paying 20% less than they paid for electricity in 1994. The total savings statewide are estimated to be 3.5 billion dollars.
- Many new entities have entered Illinois to compete for electric supply. Customers have been given the power of choice, and have selected these alternative retail electric suppliers ("ARES").
- Many industrial and commercial customers have realized significant savings from selecting the Power Purchase Option ("PPO") or an ARES; some indicate that these savings have helped them to keep their business in Illinois rather than move to a lower cost state.
- Statewide service reliability has improved dramatically.
- Over 9000 MWs of new generation has been built in Illinois by private investors. These investors, and not customers, have mustered the capital to build these plants and have borne the risk of cost overruns as well as the potential of uneconomic results in stranded costs.
- Illinois utilities have restructured operations by divesting generation, and have become more productive and efficient in order to face the emerging competitive marketplace.

Illinois now faces the end of the Restructuring Act's transition period and must make significant decisions about how power will be procured for and electric service provided to Illinois customers in 2007 and beyond. These decisions will impact the

well-being of customers in the State, as well as the business climate and economy of Illinois.

Recognizing that the major Illinois utilities' existing long-term contracts will expire January 1, 2007, this Commission in early 2004 announced a plan to host a series of meetings and workshops to examine the future of the electric market in Illinois, public policy issues surrounding restructuring of the electric industry, and critical questions concerning procurement of supply to serve customers in the post-2006 environment. At that time, the State's largest electric utilities that no longer own generation must procure power in the wholesale market.

Chairman Edward Hurley and Commissioners O'Connell-Diaz, Wright, and Ford decided to tackle these issues in five working groups (Procurement, Rates, Competitive issues, Utility Service Obligations, and Energy Assistance), each one chaired by a different convener. In May, the five working groups set out to examine an extensive list of issues pertinent to each group. The task for each working group was to achieve consensus on as many substantive issues as possible. Where consensus was not reached on substantive issues, each group was to nonetheless reach consensus on a precise definition of the remaining issues and provide a list of possible resolutions (without attribution). A sixth working group (Implementation) was to be formed if and when it became clear that there would be a need for action by legislative bodies and/or Illinois State agencies. Such a working group was in fact formed in September.

Every significant stakeholder interest was represented in the workshop process, with the participants bringing the views of consumers, power generators, financial intermediaries, utilities, units of government, environmental organizations and others to bear on the important topics that will shape the future of the electric industry in Illinois. This diverse assembly of interested parties worked in a collaborative manner to identify issues, to clarify positions, to reach consensus where possible and to understand and narrow differences where consensus was not possible.

The undertaking was well worth the time and effort it required. Much has been achieved in a relatively short time. Significant issues that in other jurisdictions might have been aired in contentious litigation settings have been explored extensively in a well organized, efficient and respectful manner by parties who, despite some differing interests, all acted in good faith to arrive at a framework for emerging from the transition period established under the 1997 Restructuring Act. The Illinois Commerce Commission commends the spirit of cooperation with which all participants approached the process, as well as the enormous commitment of time and resources that were devoted to this unique effort.

Comments of the Illinois Commerce Commission

Participants of the Post-2006 process -- stakeholders and ICC staff alike -- have provided an invaluable service to the ICC, the General Assembly and the Administration as well as to the residents and businesses of the State of Illinois. Through an intensive 5-month process in which the participants studied and debated the issues facing Illinois post-2006 the stakeholders have ultimately arrived at policy conclusions in the form of consensus recommendations. There is a consistency and symmetry in the consensus opinions of each of the working groups which in many areas aligns with that of the Commission's Staff. Stakeholders and Staff have provided clear and consistent direction to the policy-makers in the State. This Commission interprets the key findings as follows:

- Illinois has benefited greatly under the framework the General Assembly put in place in 1997. Residential customers have enjoyed one of the largest rate reductions and longest rate freezes in the country. Large customers have also reduced cost through frozen rates and market based pricing. Reliability has also improved dramatically.
- In the Restructuring Act, the General Assembly charged the ICC to "promote the development of an effectively competitive electricity market." Illinois should continue down the path set out by the General Assembly in 1997 – a measured program toward competitive markets with strong regulatory oversight will result in the greatest consumers benefits.
- A competitive procurement process will deliver the most efficient pricing to customers over the long run.
- It is critical that in a restructured environment customers be provided "choice" in a variety of forms, including the opportunity to participate in demand response programs and to interconnect distributed generation. These choices are market-based in that they allow the customer to respond to real-time market prices for power while also promoting energy efficiency and conservation.
- While competitive procurement and market development are primary goals, stakeholders insist on consumer protections in the form of mechanisms that mitigate rate volatility and encourage rate stability and continuing regulatory oversight.

The Commission submits that Illinois is well positioned to move forward in the manner outlined by the stakeholders and Staff. Illinois' utilities are financially sound and providing reliable service. Substantial progress has been made to bring the benefits of competition to Illinois energy consumers.

The Commission supports the policy choices of the stakeholders and holds in high regard the well-studied opinion of its Staff. The next steps are to seek the invaluable input of those policy-makers for whom this report is written - the Administration and the General Assembly - and to ask the Illinois stakeholders to continue to work collaboratively to develop a more specific implementation plan for Illinois consistent with the findings reflected in this report and the anticipated input of Illinois' policy makers.

As a result of this collaborative effort, key components of a post-2006 framework have been developed. As discussed in the balance of this summary, this report consists of feedback from the five working groups, a sixth working group dedicated solely to resolving the legal issues associated with implementing a post-transition approach, and significantly, the position paper of the ICC staff. Each of these reports is attached to this executive summary. The supporting documents for the reports can be found on our website at www.icc.state.il.us. There is important detail in each of those reports, and the conclusions reached by each group are discussed in the following summary.

I. Renewable Portfolio Standards (“RPS”)

Consistent with the recommendations of the Illinois Energy Task Force any post-2006 approach may incorporate a Renewable Portfolio Standard (“RPS”). We believe that any RPS implemented in a Post-2006 retail marketplace must include: Demand Side Management (“DSM”), distributed generation, and energy efficiency. It is equally important that the wholesale supply market competitively incorporates all forms of generation and alternative supply, including wind, solar, biomass, distributed generation, and actively managed demand response.

The Federal Energy Regulatory Commission’s (“FERC’s”) position has been clear in calling for each region with a Regional Transmission Organization (“RTO”) or Independent System Operator (“ISO”) to determine how it will ensure they have enough resources to meet their customers’ needs and provide long term price stability. FERC has left it up to the states to figure out how it will be accomplished and the level of resource adequacy. The auction process could incorporate FERC’s position that has been clear in calling for each region with a RTO or ISO to determine how it will ensure they have enough resources to meet their customers’ needs and provide long term price stability. However, FERC has also stated resources will have to be drawn from a mix of generation (wind, solar, biomass), transmission, energy efficiency and actively managed demand response.

The Commission considers renewable energy, conservation, distributed generation, and demand response to be closely related. These are alternative approaches to the traditional supply options that have been relied upon to meet customer demands in the past and should continue to be integrated into a long-term rate structure.

The cost of wholesale electricity can be significantly mitigated by an auction structure that allows all forms of alternative energy resources to be considered, but especially demand response, which has been shown to keep the highest cost generators out of the market.

If the objective is to create a “level playing field” in the auction process, then the state could require bids to reflect the full societal benefits and costs of all energy sources, including both traditional and alternative sources as analyzed across the full spectrum of energy infrastructure, including generation, transmission and distribution. This would enable an alternative energy source with low environmental costs or reduced pressure on the grid to compete favorably against traditional sources.

Furthermore, renewable resources are considered to have lower environmental impacts than traditional supply sources and are therefore advocated on this basis. Unfortunately, it seems that the current transition period, coupled with deregulation, has led to little or no incentive for utilities to promote renewables, efficiency, distributed generation or demand response.

As noted by the Illinois Energy Task Force, Illinois ranks in the bottom ten amongst state spending on efficiency. Alternative forms of energy are the key to a sustainable energy infrastructure, have significant environmental benefits, and reduce pressure on the grid.

We feel that before a post-transition rate structure is put in place, a framework for the promotion of competitive renewable, efficiency, distributed generation and demand response programs must be considered. Future rates can even be crafted to advance environmental objectives and to boost the growth of alternative energy resources. Toward that goal three points should be stressed:

1. Any RPS must include all forms of alternative energy and sustainable energy development including energy efficiency, distributed generation and demand response.
2. Any RPS must address any required cost recovery consistent with the consensus reached in the Rates Working Group.
3. Any RPS must consider the effect of the use of renewable resources on rates while also analyzing their net economic impact on utilities and ratepayers including health costs, electric distribution investment and related factors.

Additionally, the Illinois Commerce Commission has advocated that ISO market rules should fully support the advancement of alternative energy resources such as wind, solar and demand response. Currently, while the ISO's stated intention is to have full non-discriminatory resource rules, the two system operators in Illinois, PJM and MISO, do not allow alternative resources full access to their markets nor have they recognized the full societal benefits and costs. The Illinois Commerce Commission will continue to encourage them to consider FERC's draft standard market design policy.

To be sure if Illinois desires to create an equal playing field for alternative resources, a very important factor will be that both the auction process and ISO market rules must be consistent in their ability to foster the growth of all forms of alternative supply, including wind, solar, biomass and actively managed demand response.

II. Stakeholder Working Group Reports

A. Procurement Working Group ("PWG")

The Post-2006 Initiative procurement working group's primary task was to examine the process by which Illinois electric utilities, many of which now own little or no generation, should procure supply to meet the load of customers they remain legally obligated to serve on and after January 1, 2007. The group reviewed 12 alternative acquisition approaches, identifying the advantages and disadvantages of each option. The experience of other retail jurisdictions was studied so that decisions

to be made for Illinois are informed by the results achieved with procurement models elsewhere.

What is most significant about the procurement working group report is that the consensus items reflect the unanimous agreement of the working group participants. The consensus items endorse the General Assembly's choice of direction made in 1997 and express a commitment to take the next step toward the goals reflected in the Act of a workable competitive market. The procurement group reached consensus that a procurement approach should:

- Be accomplished through a competitive procurement method that facilitates diverse supplier participation resulting in market-based prices for power;
- Strike a balance between encouraging competitive market development and protecting consumers from market irregularities by facilitating stable rates, mitigating rate volatility and mandating ongoing regulatory oversight in the form of initial regulatory review to improve and monitor the process;
- Accommodate RPS, DSM, as well as low income assistance programs;
- Reflect lessons learned from other states.

B. Rates Working Group (“RWG”)

The RWG considered a wide variety of issues affecting retail rates in the post-2006 environment. Once again reflecting the unanimous agreement of the working group participants, the RWG reached consensus on the following:

- The acquisition costs incurred by utilities that adopt a full requirements competitive procurement process should be passed through to retail customers with no mark-up or return on the costs of power;
- The costs of energy efficiency, renewables, and demand reduction programs should be fully included in the utilities' commodity rates;
- Where procurement strategies expose utilities to risks that make hedging appropriate, utilities should at least partially hedge against variations in market prices and recover the prudent and reasonable costs of doing so.

C. Competitive Issues Working Group (“CIWG”)

The CIWG considered whether specific actions need to be taken to promote the development of competition in areas and markets in Illinois. The CIWG reached the following consensus:

- Competition in both the wholesale and retail market segments should be encouraged as complimentary and effective competition in both arenas will deliver value to customers;
- The ICC should focus on encouraging the development of serious demand response programs in Regional Transmission Organizations (“RTOs”) and

assuring that utility tariffs, rules and practices do not erect barriers to customer participation;

- Any Illinois Renewable Portfolio Standard (“RPS”) should be competitively neutral and applied equitably to electric utilities, ARES, and suppliers serving a utility's load obligations;
- An appropriate mechanism for efficient RPS compliance is a system of tradable "green tags."

D. Utility Service Obligations Working Group (“USOWG”)

The USOWG considered utilities' present obligations with respect to serving customers and whether those obligations will remain unchanged in the post-transition period. The USOWG reached the following consensus:

- The law should continue to impose a load-serving obligation for the foreseeable future on the utility. Illinois utilities should continue to bear the obligation to serve customers in a manner that is identical to that of the transition period;
- The utility should continue to offer a regulated product to customers as currently required under the Public Utilities Act (“PUA”);
- Utilities should offer services that strive for price stability for the power and energy component, at least for residential and small commercial and industrial customers who either have no alternative provider option or do not wish to take service from an alternative provider.

E. Energy Assistance Working Group (“EAWG”)

- The Low Income Energy Assistance Program (“LIHEAP”) in Illinois has been a valuable program with a significant positive impact. Illinois is a leader in terms of available funding for the program;
- The current definition of eligible program participants should remain;
- Energy efficiency education programs could have a positive impact on improving LIHEAP and should be further evaluated;
- There should be no effect on state energy assistance programs caused by the method(s) of procuring power supplied by ARES in the post-2006 environment.

III. Illinois Commerce Commission Staff Report

A. Purpose of Staff’s Report

Staff states that the purpose of its report is not just to relay what has already been reported by the Post 2006 Initiative working groups; it is to make practical recommendations. As previously noted, the working groups were charged with reaching consensus positions on the various issues. Common ground was found on numerous issues, and identification of common ground is an important first step towards preparing for the post 2006 era. However, where consensus was not reached on

substantive issues, action is still required. Thus, Staff utilized the consensus reports of the working groups as springboards for writing its report. Its report does not attempt to exhaustively address all the discussions of the working groups, but Staff makes recommendations in each of the main issue areas.

Staff avers that its recommendations were guided by its commitment to the goals of the Public Utilities Act (“ the PUA”). In particular, while the Restructuring Act envisioned greater reliance on market forces, and charged the Commission “to promote the development of an effectively competitive electricity market that operates efficiently and is equitable to all consumers,”¹ the Act retains Commission authority to set just and reasonable rates for services that have not yet been determined to be competitive. Thus, while promoting development of competitive markets, the Commission continues to possess a regulatory mandate to ensure “the provision of adequate, efficient, reliable, environmentally safe and least-cost public utility services at prices which accurately reflect the long-term cost of such services and which are equitable to all citizens.”² After 2006, utilities will still be responsible for providing electricity to consumers, and the Commission must determine how to price that electricity, subject to the limitations and constraints imposed by both legal and economic realities.

As one might gather from Staff’s Introduction to the Post 2006 Initiative Whitepaper (posted on the Commission’s web site on February 19, 2004), Staff’s main concern relates to the degree of competition in the retail and wholesale electricity marketplace. Other concerns of Staff involve limitations in the transmission system, and concentration among owners of generation available to Illinois and the potential impacts upon prices for power and energy in the post 2006 era. Among the most urgent matters to be resolved, recognizing that transmission and generation issues are almost entirely beyond the Commission’s authority, is how the Commission can work with multi-jurisdictional authorities to best mitigate the risk of experiencing inefficiently high prices in the post 2006 era.

B. Procurement

A list of Staff’s procurement-related recommendations are as follows:

- The Commission should remain receptive to more than just one procurement plan, recognizing differences in size and situation among Illinois’ electric utilities.
- Large Illinois utilities that do not own significant generation resources should be encouraged to procure their electricity via a vertical tranche auction, as exemplified in Scenario 1 of the Procurement Workshop Report. This assumes that transmission systems and wholesale markets can appropriately accommodate such auctions.

¹ 220 ILCS 5/16-101A (d)

² 220 ILCS 5/1-102

- The Commission should clarify its authority to implement the use of any given procurement methodology, in general, and a vertical tranche auction, in particular.
- Illinois policymakers should continue to work to ensure that PJM's and MISO's Locational Marginal Pricing ("LMP") and Financial Transmission Rights ("FTR") markets are fully functional and completely resource non-discriminatory before the end of 2006.
- Illinois policymakers should continue to work to ensure that market "seams" between MISO and PJM are eliminated.
- Illinois policymakers should work to ensure that there exist regional markets for ancillary services and capacity within and between MISO and PJM.
- Illinois policymakers should work to ensure that the winners of a vertical tranche supply auction are given LSE status for purposes of PJM and MISO tariffs.
- Illinois policymakers should work to ensure that auction winners can receive annual FTR allocations from MISO and PJM.

C. Rates

Staff's recommendations related to rate design are as follows:

- The Commission should adopt the RWG's agreement to separately present the delivery and generation components of ratepayer bills.
- The Commission should follow the counsel of the RWG and conduct a single proceeding to determine a common delivery service rate for both bundled and unbundled customers for each utility in the post 2006 era. Those rates will foster competition and streamline the regulatory process. This should be implemented within the next electric rate case for each utility.
- Staff recommends that the Commission continue to employ the cost-based ratemaking approach to the delivery component of bundled rates that it developed and refined in the previous delivery service proceedings.
- For the power and energy component of bundled service, the Commission should apportion auction prices to ratepayers according to their respective load factors and/or to other load characteristics to reflect the differing contributions of customers to costs.
- The Commission should examine whether larger customers would be better served by having fixed rather than hourly prices. Furthermore, if an hourly price plan is adopted, Staff recommends the Commission consider limiting

that plan to only the largest utility customers, perhaps in the 3 MW and above range.

- The Commission should examine whether a monthly true-up is necessary or whether utilities should absorb surpluses or shortfalls that result from an auction process.
- The Commission should continue to make utility tariffs and ratemaking approaches more uniform. Within the next electric rate case for each utility, Staff will make recommendations to make tariffs and rate structures more uniform.
- The Commission should follow a policy on renewable energy that is consistent with the consensus positions of the RWG. The Commission should also approve rates that promote efficient conservation of energy.

D. Competition

Staff's recommendations related to competitive issues are as follows:

- Modify the PUA to permit electric suppliers to use telemarketing-based customer enrollment methods.
- Eliminate the authority for the 24-Month Minimum Re-enrollment Requirement in Section 16-103(d).
- If utilities use auctions to procure power and energy, permit small-use customers to move between alternative suppliers and utility service without penalty.
- Do not strongly advocate large-scale customer migration programs such as municipal aggregation or programs in which customers are transferred to alternative suppliers.
- Modify Section 16-113 to permit the Commission to set standards for competitive declarations or delete the section.
- Open a proceeding to consider modifications to Part 451.
- Endorse the "Option A" recommendations of the Competitive Working Group.
- Consider endorsing a second customer education program to inform small-use customer about recent and upcoming changes in the electric industry, if the means can be found to fund the program.
- Endorse industry participants' interest in establishing an independent working group to promote uniformity in electronic transactions, and facilitate its efforts

through the use of the Commission's internet site for posting working group communications and reports.

- Continue to encourage additional uniformity in other areas, including customer billing issues.

E. Utility Service Obligations

Staff's recommendations related to service obligations are as follows:

- Do not modify the utilities' existing service obligations to those customers whose service has not been declared competitive.
- Competitive customers should be permitted to obtain service at the fixed rates available to non-competitive customers.
- As noted above, modify Sec. 16-113 to permit the Commission to set standards for competitive declarations or delete the section.

F. Energy Assistance

Staff's recommendations concerning energy assistance programs are as follows:

- If the current level of funding is maintained, eligibility for the Low Income Home Energy Assistance Program should remain the same (150 percent of federal non-farm poverty level), and households with elderly or disabled persons should be offered a priority application period.
- The Illinois Department of Public Aid would be the proper agency to lead the discussion on development of a percentage of income plan.
- If the Commission determines amendments are needed to current disconnection, reconnection rules in order to halt the cycle of utility disconnections in the spring and summer, followed by reconnection in the fall and winter, workshops would allow parties to work out details to provide a system that is fair to all low-income customers.
- The Commission should defer to the General Assembly to decide whether the energy assistance fund should continue after December 2007.

IV. Implementation

The Implementation Working Group ("IWG") was assigned the task of examining the reports of the five working groups, Energy Assistance, Utility Service Obligations, Rates, Competitive Issues, and Procurement, to determine how consensus items and significant non-consensus issues could be implemented. The IWG was composed of the conveners of the five working groups and the ICC's Office of General Counsel.

Generally speaking, IWG undertook the following process: Each working group convener prepared an initial implementation draft report of his or her respective working group. In most instances, the review considered the questions originally posed in Staff's White Paper, together with consensus items and significant issues on which consensus could not be reached. That initial draft was then made available to all participants of the respective working group for comment. Any comments received by the convener were then incorporated into a final draft report. The final draft implementation report of the five conveners was again circulated among the respective working group participants for final review and comment. To the extent time permitted, any final comments received were incorporated into each group's final implementation report, which was forwarded to the IWG convener. Upon receipt of each of the five implementation reports, the Office of General Counsel provided its comments to the proposed implementation methods. Please note that conveners and group participants have not had an opportunity to review or respond to the Office of General Counsel's comments.

In most cases the Office of General Counsel concurs with the implementation method(s) suggested by the working groups. In certain instances the Office of General Counsel provides additional considerations or develops the suggested implementation method more fully.